October 31, 1991

COORDINATED ISSUE
MOTOR VEHICLE INDUSTRY
DOLLAR-VALUE LIFO
DEFINITION OF AN ITEM

ISSUE

Whether an item, for purposes of calculating the value of the taxpayer's inventory under the dollar-value LIFO method as authorized by Regulation 1.472-8, is defined by reference to a particular vehicle as to make, year, model, body style, standard equipment, options, and other factors.

FACTS

Motor vehicles are manufactured with a wide variety of makes, models, body styles, colors, and options. These factors are specified on the order prepared for each vehicle by a consumer, a dealer, a distributor, or the manufacturer. Additionally, each vehicle is designated as to its model year.

Manufacturers have traditionally made annual changes to vehicles to enhance their marketability and to meet Federal and State requirements. These include: interior and exterior trim, minor exterior body parts, major structural design and styling, drive train, and body family, or platform as it is called in the industry. These changes may or may not be directly reflected in the price of the vehicle. Trim changes usually occur every year and include the interior trim, exterior bumpers, paint, and front and rear styling. Minor changes to exterior body parts occur every two to three years and include fenders, hood, and trunk lid, butnot to any body structural part. A major change to structural design and styling may occur every four years and includes distinctive changes to the exterior body parts which may change the dimensions of the vehicle but not the drivetrain. Changes to the drivetrain occur every two to three years and include engine displacement, type of engine, transmission, and drive wheels. The change to the body family or platform occurs when an entirely new vehicle is designed and involves a design of most of the parts of a vehicle. The new vehicle may take over the name of a previous model or be given a new name. For 1988, there were 42 body families for domestic passenger cars, that included 254 different models. There were also 337 models of import passenger cars sold in the U.S.A.

Usually, manufacturers change the price of vehicles when the model yearchanges, and occasionally during a model year. These changes may include the base price, the price of the options, the options that are includedin the base price, the warranty provisions, and the sales incentives that are offered to the distributors, dealers, or consumers.

Most taxpayers in the motor vehicle industry file tax returns on acalendar year basis. The model year for the industry, however, generally changes on October 1. Consequently, the majority of vehicles on hand at the end of a taxable year are one model year newer that those on hand atthe end of the previous taxable year. In order to encourage the sales of vehicles that are on hand when the model year changes, manufacturers normally give a cash rebate to the distributors and dealers for each prior model on hand. Since this allowance is a reduction to the cost of the vehicle, it is possible that a taxpayer may have on hand at the endof one taxable year, a vehicle whose cost, after deducting the allowance, is less than the cost of a vehicle of the same model year that wascomparably equipped and on hand at the end of the preceding taxable year.

LAW

Section 1.472-8(e)(2)(i) of the Regulations provides that under the double-extension method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit costand current-year unit cost. Under the link-chain method, the quantity of each item in the inventory pool at the close of the taxable year is extended at both the beginning-of-the-year unit cost and the end-of-the- year unit cost. Neither the Code nor the regulations define what constitutes an item.

The tax court in Wendle Ford Sales, Inc. v. Commissioner, 72 T.C. 447(1979), determined that 1975 Fords with solid-state ignitions and catalytic converters were not new items when compared to 1974 Fords that did not have solid-state ignitions and catalytic converters. Whether or not a Ford had either of these features was determined by the manufacturer. Their cost was never separately stated on the dealer’s invoice. The court decided that the entire car was the item and not the individual components or parts.

DISCUSSION

Throughout this discussion it is assumed that any vehicle being discussed is not a new item. Whether a vehicle is a new item will be a separate coordinated issue.

The LIFO regulations were written under the assumption that every taxpayer can determine what "items" are in inventory at the end of ataxable year, and that a comparable "item" was in inventory at the end of the base-year, or the preceding year for taxpayers using link-chain. The regulations state that no adjustments are to be made to the cost of an "item" if the "item" is on hand at the end of the base-year, or the preceding year if the taxpayer has elected link-chain. When the list of optional equipment for cars is combined with the more than 600 different passenger car models, there is a tremendous number of differently equipped cars that could be on hand at the end of the year. Additionally, yearly changes are made to body style, standard equipment, options, rebates, warranties, features, and other factors. These differences and changes must be considered in making the LIFO computations to avoid gross distortions. The cost of two cars of the same model can vary by thousands of dollars depending on how they are equipped.

The tax court decided in Wendle Ford that the "item" to double-extend is the entire car as it comes from the factory, and that minor differences from one year to the next did not cause cars to be different "items." While the court did not specifically address the issue of factory- installed options, it appears that it is reasonable to conclude that the cost of factory-installed options are to be included in the cost of the "item" being double-extended.

Finally, there is no case law on whether to compare the cost of a current model with a current model of the preceding or base-year, or whether to compare the cost of a prior-year model on hand with the same model in the preceding year. For example, a taxpayer on December 31, 1988 may have on hand a 1988 model car whose inventory cost has been reduced by a manufacturer’s allowance, as well as a 1989 model of the same car whose cost has not been reduced by an allowance. Similarly, the taxpayer on December 31, 1987 may have had on hand a 1988 model not reduced by a manufacturer’s allowance and a 1987 model whose inventory cost has been reduced by an allowance. Should the cost of the 1988 model on hand on December 31, 1988 (which has been reduced by a manufacturer’s rebate because it is a prior-year model) be compared with the cost of a 1988 model car on hand on December 31, 1987, comparably equipped (which has not been reduced in cost by a manufacturer’s rebate), or should the 1989 model be compared with a similar 1988 model? The intent of the LIFO regulations would require the cost of the 1989 model to be compared with a 1988 model, both being current models at the end of each year.

CONCLUSION

While it may not be possible to compare all of the aspects of vehicles on hand at the end of two different taxable years because of differences in make, year, model, body style, standard equipment, options, and other factors, appropriate adjustments should be made to the cost of the vehicles on hand at the end of the prior taxable year to account for as many of these factors as possible. The prices of all factory installed options are readily available to distributors and dealers. For body style, standard equipment, options and other features that are available at one point and not another, the adjustment should be based on the stated or implied price when available and factored in as a percentage of the base vehicle cost.

An example follows:

The standard equipment on the 1987 and 1988 Buick Electra Estate Wagons is the same except for the following:

a. 6-way power driver's seat was an option on the 1987 model that cost the dealer $179 but was standard on the 1988 model.

b. Third seat was an option on the 1987 model that cost the dealer $187 but was standard on the 1988 model.

The dealer cost for the 1987 model including destination charge but with no optional equipment was $15,773. The 1988 cost was $16,837. The 1987 cost should be increased to $16,139 for the cost of the items that were made standard in 1988. ($15,773 + 179 + 187 =$16,139)